

Jay Bennett
Director-
Federal Regulatory

SBC Communications Inc.
1401 I Street, N.W.
Suite 1100
Washington, D.C. 20005
Phone 202 326-8889
Fax 202 408-4805

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Memorandum of Ex Parte Communication

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ms. Magalie Salas
Secretary
Federal Communications Commission
445 12th Street, S. W.
Street Lobby – TW A235
Washington, D.C. 20554

Dear Ms. Salas:

Re: *CC Docket No. 98-227- Petition of SBC Communications, Inc. for Forbearance from Regulation as a Dominant Carrier for High Capacity Dedicated Transport Services in Fourteen Metropolitan Service Areas*

Today the attached study "An Assessment of the Competition in the Local Private Line and Special Access Market" was delivered to Ms. Jane Jackson, Mr. Rich Lerner, Ms. Tamara Preiss, Mr. Doug Galbi, Mr. Jay Atkinson, and Mr. Aaron Goldschmidt. This study prepared by the Yankee Group examines the national market for private lines and special access services. Consistent with the results of other studies, the Yankee Group concludes that competitive providers have captured significant portions of these markets and that "market share erosion is clear evidence that the national Special Access market is competitive."

We are submitting the original and one copy of this Memorandum to the Secretary in accordance with Section 1.1206 of the Commission's rules. Please stamp and return the provided copy to confirm your receipt. Please contact me at (202) 326-8889 should you have any questions.

Sincerely,

A handwritten signature of Jay Bennett in dark ink, written over a horizontal line.

cc. J. Jackson, R. Lerner, T. Preiss, J. Atkinson, D. Galbi, A. Goldschmidt

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An Assessment of the Competition in the Local Private Line and Special Access Market

**Prepared for
SBC**

**Prepared by
the Yankee Group
31 St. James Avenue
Boston, MA 02116
June 9, 1999**

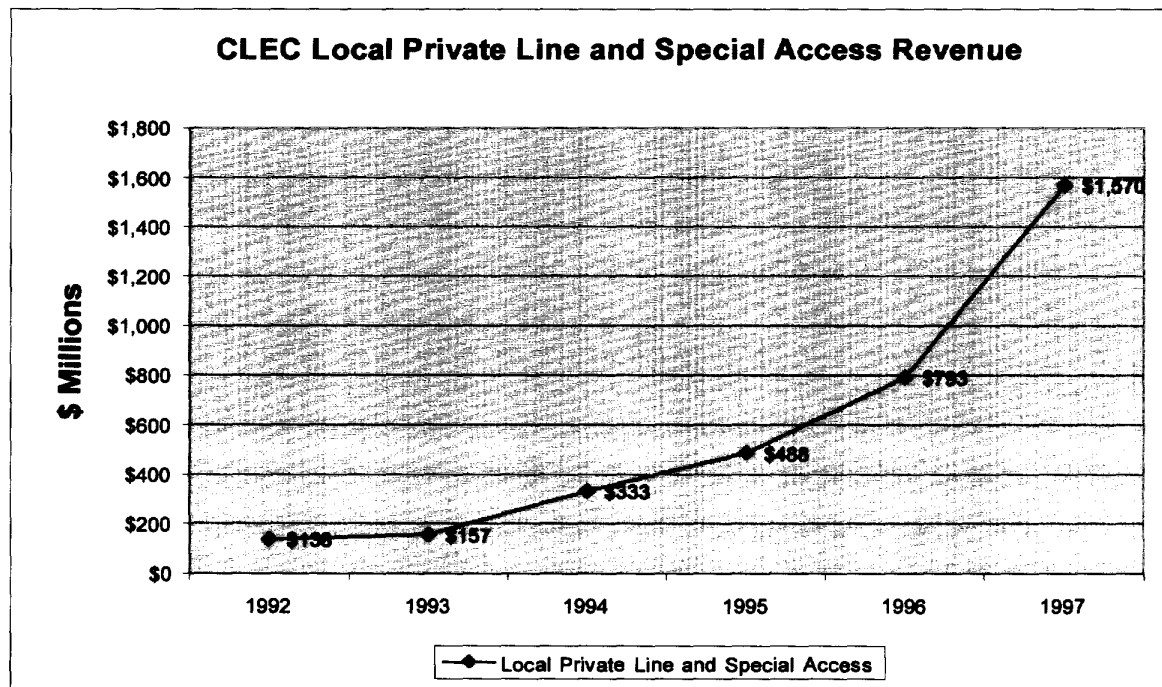
Introduction

Local private line and special access services, once virtually the exclusive domain of the incumbent local exchange carriers (ILECs), have been under increasing attack from a variety of alternative service providers. First came the competitive access providers (CAPs), a new class of carrier that entered the local market several years ago specifically to offer these services. During the early to mid 90's, CAPs such as TCG and MFS, were successful in establishing alternative facilities-based local networks in large metropolitan areas and persuading businesses to use their local private line and special access services as a secondary source that provided redundancy and survivability on mission critical routes.

With the advent of the Telecommunications Act of 1996, the CAPs were allowed to provide not only dedicated access but also switched access services and the CAPs became competitive local exchange carriers (CLECs). Having established themselves as credible alternative providers of dedicated services, the CLECs' business began to take off. Exhibit 1 shows the growth of the CLECs local private line and special access revenues.

Exhibit 1: CLEC Local Private Line and Special Access (\$ Millions)

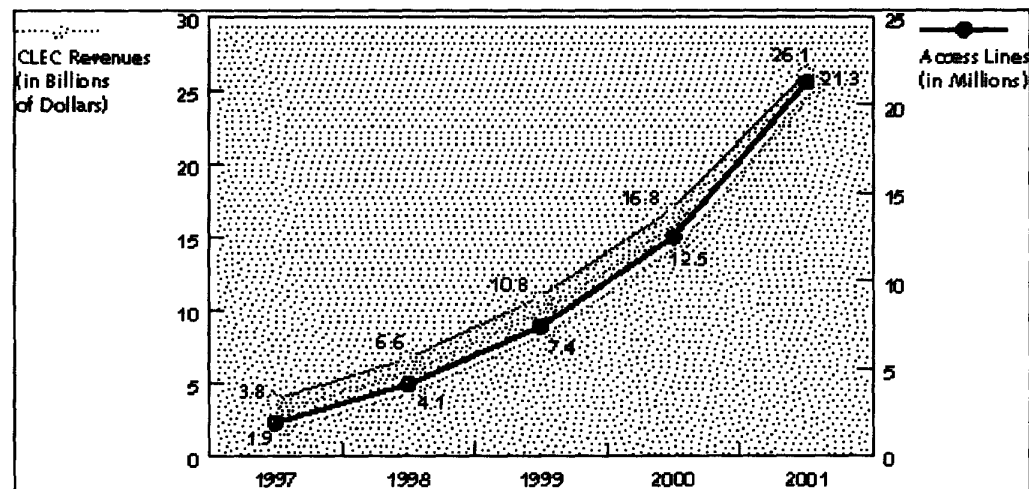
Source: FCC and The Yankee Group, 1999



Our analysis of the current and future market conditions for the CLEC segment is provided in Exhibit 2. We expect that the CLECs' revenues will dramatically increase over the next several years.

Exhibit 2: CLEC Access Lines and Revenues

Source: the Yankee Group, 1999



Within the past year many of the Tier I CLECs were acquired by the top interexchange carriers (IXCs). For example, TCG was acquired by AT&T and MFS, Brooks Fiber and MCIMetro, the CLEC subsidiary of MCI were all acquired by WorldCom. The acquisitions add a new dimension to the competition in the local market. With the IXCs' deep pockets, ready access to customers, and marketing savvy, the former CLECs were able to grow rapidly adding more business access lines than all of the Regional Bell Operating Companies (RBOCs) combined throughout most of 1998.

This report analyzes the impact of competition specifically on the local private line and special access market revenue generated by all carriers in this market. We chose revenue instead of circuits as the basis for this report because the revenue figures were readily available and consistently reported to the FCC by the various competitors and incumbents. While an analysis based on the actual number of circuits in service by carrier type is arguably a better measure of the level of competition in this market, aggregate circuit information is not publicly reported. To obtain the data the company would have to conduct a primary research study including a survey of market participants. A study to calculate unit share would need to have adequate sampling and controls to manage reporting bias, and use market analysis to extrapolate individual carrier share results where information was unobtainable. SBC contracted a market share study from Quality Strategies (QS) of Washington DC. The methodology outlined in the study report appears to contain these processes. In general we find the QS circuit share results consistent with our revenue market share findings.

The Yankee Group analysis reflects the level of competition in the U.S. local private line and special access market. Naturally, the level of competition in any particular, city or region will be different. Clearly competitors' focused initially on businesses in the top urban markets, thus heightened levels of competition exist in those markets. Although smaller markets have begun to experience competition, the level of competition is less intense. Overall based on the presence of competitors and the revenue market share of the various carrier types, we believe the U.S. local private line and special access market is competitive nationally.

Sources of Data

This analysis relies on three primary sources of data: two reports from the Federal Communications Commission (FCC) *Statistics of Communications Common Carriers (SOCC)* and *Telecommunications Industry Revenue (TIR): 1997* and finally the Yankee Group's own research. The SOCC is an annual report compiled by the FCC from data reported by the largest U.S. ILECs. Of the estimated 1,300 local carriers in the U.S. in 1997, only 54 were required to report this data to the FCC. Given the historical dominance of the large ILECs, including the RBOCs, GTE and Sprint, this report has traditionally provided a comprehensive view of the local market. This becomes less true as the competitive carriers gain market share.

The TIR was compiled by the FCC from data gathered from 2,267 service providers of all types e.g., ILECs, IXC, CLECs, wireless carriers, etc. The carriers were required to report their revenues in a consistent and detailed fashion to determine their liability for funding Universal Service. Those carriers not required to provide revenue data for Universal Service were required to provide revenue data for Telecommunications Relay Services (TRS). The TRS worksheets provided revenue data from another 1,138 carriers. The FCC report, *Telecommunications Industry Revenue (TIR): 1997*, combines the data from both of these sources to provide the most comprehensive look at telecommunications revenue in the U.S. The report reflects one full year of data (1997) reported according to the new requirements and historical data gathered from a variety of sources. This report was also used as a source in this analysis.

Both of these FCC reports use the Uniform System of Accounts (USOA) definition of Local Private Line and Special Access revenue thus ensuring that the data from these two sources are consistent. All carriers, regardless of type, that were required to report revenue data to the FCC for use in either of these reports were required to use these definitions when classifying the revenue reported. USOA defines these accounts as follows:

Local Private Line (Part 32.5040)

"This account shall include revenue derived from local services that involve dedicated circuits, private switching arrangements, and/or predefined transmission paths, whether virtual or physical, which provide communications between specific locations (e.g., point-to-point) communications. It includes revenue from subvoice grade, voice grade, audio and video program grade, digital transmission and local private network switching as well as the revenue from administrative and operational support services associated with private network services and facilities, e.g. charges for company-directed testing, expedited installation and service restoration priority."

Special Access (Part 32.5083)

"This account shall include all federally tariffed charges assessed for other than end user or switched access charges referred to in Account 5081, End User Revenue, and Account 5082, Switched Access Revenue."

In addition to these two primary the Local Private Line and Special Access category also contains any intrastate special access revenues in Account 5084—State Access Revenue (see definition below).

Special access is one of four subaccounts under the Network Access account. For clarity the definitions of these accounts are also included here.

Network Access (Part 32.5080)

"(a) This account number shall be used by Class A and Class B telephone companies to summarize for reporting purposes the contents of Accounts 5081 through 5084. It shall include revenue derived from the

provision of exchange access services to an interexchange carrier or to an end user of telecommunications services beyond the exchange carrier's network.

(b) Accounts 5081 through 5083 are for federally tariffed access charges while Account 5084 is to be used for state tariffed access charges."

End User Revenue (Part 32.5081)

"This account shall contain the federally tariffed monthly flat rate charge assessed upon end users."

Switched Access Revenue (Part 32.5082)

"This account shall consist of federally tariffed charges assessed to interexchange carriers for access to local exchange facilities."

Special Access Revenue (Part 32.5083)

Defined above.

State Access Revenue (Part 32.5084)

" (a) This account shall include all state tariffed charges assessed by local exchange carriers upon interexchange carriers and end users for access to the local exchange network for intrastate telecommunications.

(b) Billing and collections services provided under exchange access tariffs shall be included in Account 5270, Carrier Billing and Collection Revenue."

These accounts contain all wholesale and retail revenue generated by the reporting carriers for these account categories. Carriers reporting revenue data for the *Telecommunications Industry Revenue Report (TIR)* included:

- Incumbent Local Exchange Carriers
- Pay Telephone Providers
- Competitive Access Providers (CAPs)
- Competitive Local Exchange Carriers (CLECs)
- Local Resellers
- Other Local Exchange Carriers
- Private Carriers
- Shared Tenant Service Providers
- Cellular Service Carriers
- Personal Communications Service (PCS)
- Paging Service Providers
- SMR Dispatch and Other Mobile Service Providers
- Interexchange Carriers (IXCs)
- Operator Service Providers (OSPs)
- Prepaid Calling Card Providers
- Satellite Service Carriers
- Toll Resellers
- Other Toll Carriers

The final source of data is the Yankee Group. The Yankee Group has been analyzing the competitive local market since the advent of the CAPs. Our data is compiled from annual and other company reports, discussions with the companies' executive and other managers, and other primary and secondary research.

The analysis reflects the Yankee Group's many years of experience in the local exchange market as well as the entire telecommunications industry.

Comparison of Studies Conducted for SBC by the Yankee Group and Quality Strategies

This is the second study commissioned by SBC since November 1998 to assess the level of competition in the local private line and special access market. The first was a study conducted by Quality Strategies (QS) of Washington D.C. in November 1998. The QS study assessed the level of competition in specific MSAs within the SBC territory. The current study, conducted by the Yankee Group, assesses the national U.S. market for these services. Beyond the obvious differences in the scope of the studies there are other differences in nomenclature and in the study base that must be understood if these studies' results are to be compared.

The most fundamental difference is that the QS report assesses market share based on the number of high capacity circuits provided by each carrier. The Yankee Group study is based on revenue derived from local private line and special access as defined by the USOA. As noted above, USOA's private line and special access categories include revenue from dedicated low-speed analog circuits (56Kbps) and digital circuits, DS0, as well as high capacity dedicated circuits such as DS-1, DS-3 and OC-x. Additionally, these accounts also contain revenue from switched data services such as ATM, Frame Relay, etc.

The QS study focused on the facilities-based High Capacity Market and segments that market into two parts: the Provider Market and the Transport Market. They define the Provider Market as "DS-1 and DS-3 circuits provisioned by a facilities-based local telecommunications provider (either SBC or a competitor, over their own facilities). These circuits are purchased by end-users to transmit voice and data traffic between end user locations or from the end user's premise to a POP or competitor's switching center."

QS defines the Transport Market as: "DS1 and above circuits provided by SBC or a competitor over their own facilities and purchased by carriers to transmit voice and data traffic from one POP to another or to transmit voice and data traffic from a POP to a Central Office or tandems (for distribution). Transport circuits are purchased by one communications company from another communications company."

The QS Provider and Transport Market equate roughly to the retail and wholesale sides respectively of the local private line and special access markets in the Yankee Group study. In 1997, the total local private line and special access market in the U.S. was \$8,282 million. The retail segment was \$3,739.6 million and the wholesale segment was \$4,542.1. However, these revenues include revenue not only from facilities-based providers but also resellers or non-facilities based providers.

Using a facilities-based market share methodology, QS shows that SBC's market share in the cities studied ranges from 49.3% to 74.7%. Based on national revenue data, the Yankee Group estimates that the competitors have approximately 25% of the local private line and special access market. In spite of the differences, these studies are consistent based on the following:

- Competition is more intense among the business communities in large metropolitan areas (Tier I) such as those studied by QS.
- The ILECs, including SBC, still provide much of the high capacity circuits in Tier II and Tier III cities although competition is emerging in these areas.
- The Yankee Group data includes low speed analog, and DS0 circuits as well as ATM, Frame Relay and other switched data services revenue. These services are not the primary focus of the competitors.
- The ILECs are positioned as a premium service provider and generally price retail and wholesale dedicated services higher than the competitors, and CLECs often undercut ILEC

prices to enter these markets. These two factors skew the relationship between number of circuits in service and the revenue derived from these circuits.

In short although the percentage market shares in the two studies are not directly comparable, they are consistent in their overall conclusions. Both support the conclusion that there is substantial competition in the local private line and special services market.

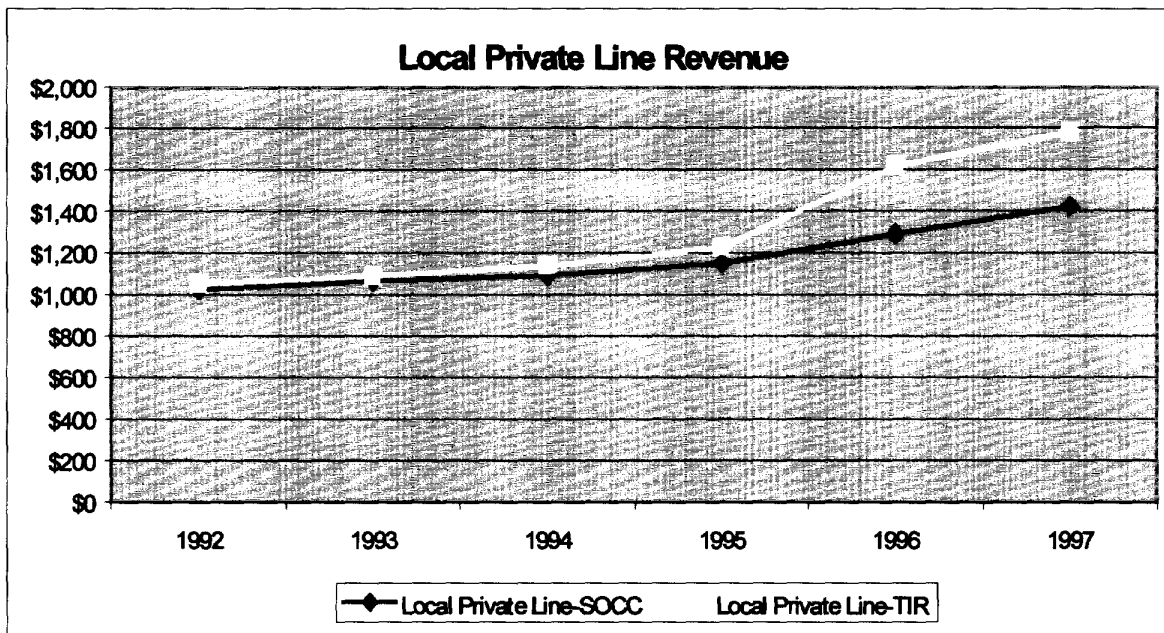
Local Private Line

Local private line and special access revenue includes the revenue from dedicated access and transport services such as DS0, DS1, DS3, etc. as well as switched data services such as frame relay, ATM, etc. As noted above, competition has been primarily focused on the dedicated access and transport segment of this market. Exhibit 3 shows that the large ILECs (local private line-SOCC) accounted for virtually all the revenue in this category (local private line-TIR) in 1992. By 1997, we estimate that the total, local private line market was \$1,779 million and the large ILECs' revenues were \$1,423 million or 80% of the total market. Due to changes in revenue reporting requirements, the total local private-line revenue for 1997 was derived, all other figures in Exhibit 3 were reported by the FCC. In deriving this data we assumed that the large ILECs maintained the 80% revenue share of this market they had in 1996. We believe this is a very conservative estimate. As the market trend shows ILECs have lost approximately 5% per year on a cumulative basis from 1992 to 1996, and the rate of loss accelerated in recent years with a 15% loss in market share from 1995 to 1996.

It is also interesting to note the accelerating growth rate for this segment. The compound annual growth rate for the large ILECs in this segment was 6.8% from 1992 to 1997 while the total market grew at over 11% for the same period. The year over year growth shows the same level of disparity. In 1995 year over year growth in the large ILEC segment was approximately 5% and in 1996 it was over 12%. For the total market segment the 1995 rate was 7.7%, jumping to over 31% in 1996. While there are many factors driving the accelerated growth of this market, a key factor is the increased level of competition.

Exhibit 3: Local Private Line Revenue (\$ Millions)

Source: FCC SOCC, TIR and the Yankee Group, 1999

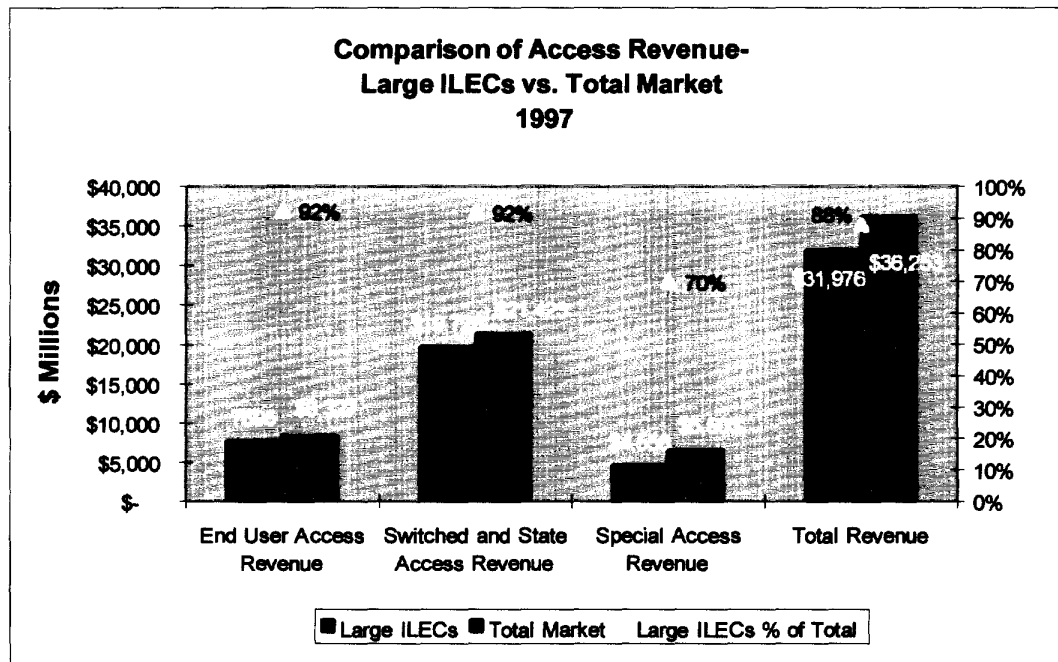


Special Access

While it is possible to create a similar trend analysis for total network access revenue, the historical data is not available for the total, special access market segment alone. However based on the revenue data available for 1997, Exhibit 4 provides a snapshot of the market. While the large ILECs have 92% of End User and Switched and State Access revenue, they only have 70% of the Special Access segment and consequently the large ILECs control only 88% of the Total Network Access revenue. We believe this market share erosion is clear evidence that the national Special Access market is competitive.

Exhibit 4: Comparison of 1997 Access Revenue-Large ILEC vs. Total Market

Source: FCC and The Yankee Group, 1999



The Impact of Competition

The CLECs have historically reported their local private line and special access revenue as an aggregate rather than as separate components. Exhibit 1 clearly shows that the CLECs are enjoying enormous growth in this segment. Not only are the total revenues for this segment growing but also the rate of growth has accelerated each year from 1995 (47%) to 1997 (98%). We fully expect that this growth will continue. The impact of wireless carriers and IXC's on this market was hardly noticeable in 1997, as they predominately resold the services of ILECs and CLECs. Of course as noted earlier, the IXCs' acquisitions of several Tier I CLECs is quickly changing the face of competition in the local exchange as the IXCs become facility based local market participants. Notably, the vertical supply alignment of these mergers will not fully be identified in future revenue statistics and market share studies, since the special access revenues of the acquired company will shift from market revenues to internal operating costs.

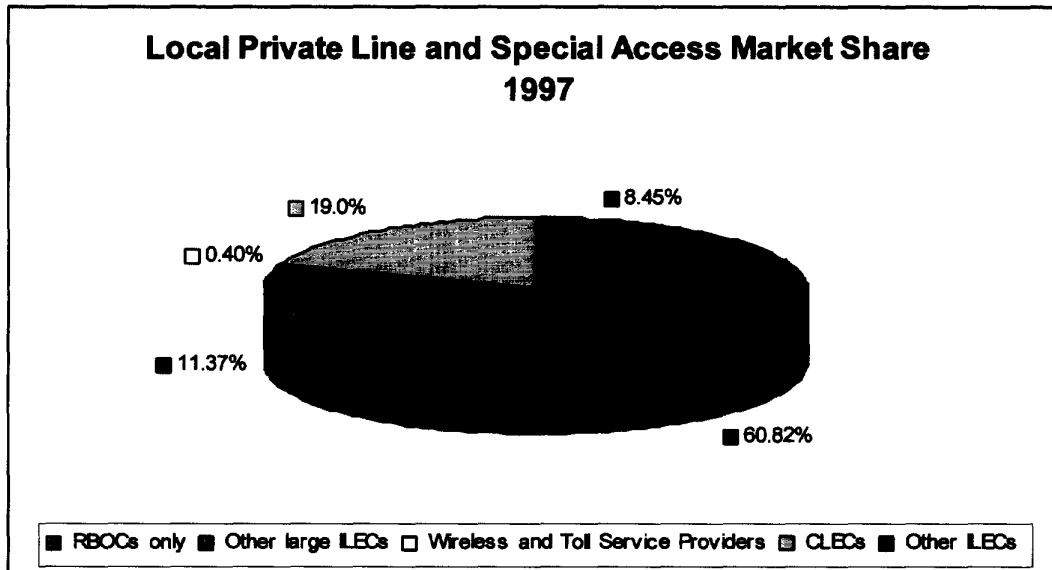
Market Share

In 1992 the ILECs including the RBOCs had virtually all of the local private line and special access revenue. The total, local private line and special access revenues in the U.S. market for 1997 were \$8,282 million. The data in Exhibit 5 shows that as of 1997, the incumbents had lost approximately 20% of the national market revenues to CLECs.

As important as the estimated 1997 market share is, the rate of growth for the two dominant segments is equally important. From 1992 to 1997 the large ILECs grew at a CAGR of 12% while the CLECs had a

Exhibit 5: Local Private Line and Special Access Market Share 1997

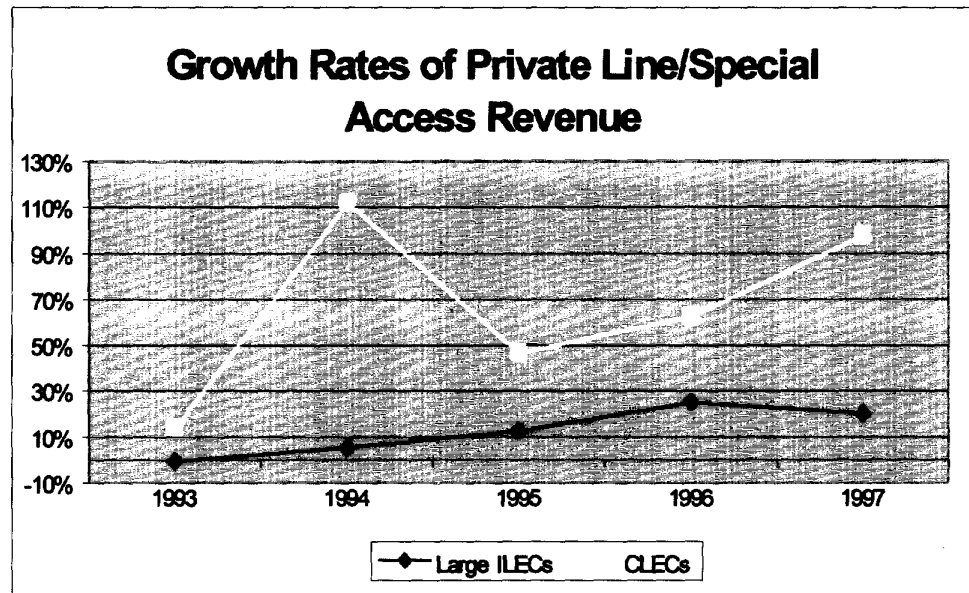
Source: FCC and The Yankee Group, 1999



CAGR of almost 63% for the same period (Exhibit 6). While the CLECs were growing from a much smaller base, the most recent years show that even though the CLECs revenue base has grown significantly, the growth momentum continues. In 1997, the CLECs had year over year growth of 98% while the large ILECs grew at a much slower 20%. The Yankee Group believes that the CLECs' momentum in these segments continued through 1998. We expect the CLECs to continue growing both dedicated and switched access lines and revenue through 2002 as shown in Exhibit 2. At the same time the CLECs will be diversifying their revenue mix which is currently heavily dependent on private line and special access revenue.

Exhibit 6: Growth Rates for Local Private Line and Special Access

Source: FCC and The Yankee Group, 1999



In this analysis we assume that the CLECs will grow their private line and special access revenue at a declining rate over 1997 (75% in 1998 and 50% in 1999), and that the ILECs will grow their portion of this segment at 20% (the same rate as 1997). Using these realistic and perhaps conservative estimates, by year-end 1999 the CLECs will have approximately 30% share of this market and based on our projections the CLECs currently have about 25% of this market.

Conclusions

Given that approximately 25% of the national private line and special access market is in the hands of competitive providers, it is fair to conclude that the private line and special access market is competitive. We base this assessment on the industry judgement that AT&T's loss of 25% to 35% share of the long distance market was evidence of a competitive environment in that market segment.

There are analogies between the spread of competition in the long distance market and the private line/special access segment. For example, presubscription which was the primary enabler of long distance competition was deployed first in the most densely populated areas. Similarly alternative providers have and will continue to focus on businesses in the top urban markets. Consequently, although nationally the incumbents' market share is eroding, this may not be true in all of the incumbents' jurisdictions. In short while the national market is competitive any particular local market may not be. The same was true with long distance.

This analysis was geared to what is demonstrable today and likely to occur in the very near term based on the trends in this segment of the market. However, the influx of the IXC's is likely to have an enormous impact in 1999 and beyond. The AT&T/TCG merger just concluded in July 1998, and the MCI WorldCom deal was only consummated in September 1998. Both of these companies have identified the local market as a key priority in their revenue growth plans. As these behemoths bear down in earnest on the local

exchange in 1999, it is likely that the growth rates for the former CLECs they acquired, and therefore the CLEC segment in general, will be even higher than we currently predict.